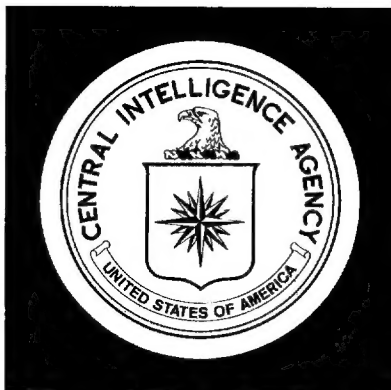


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ECONOMIC INTELLIGENCE WEEKLY

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**FRANCE: PROSPECTIVE LEFTIST VICTORY HAVING
LITTLE EFFECT ON THE ECONOMY TO DATE**

The strong possibility that the Socialist-Communist alliance will win control of the French Government next March so far appears to be having only moderate impact on investment decisions while severely depressing stock market prices.

Our necessarily subjective judgment that the economy is pretty much on course despite the leftist threat results from analysis of (a) investment in plant and equipment, (b) international capital movements, and (c) prices of securities. Since we obviously could not know what these indicators would have shown under different political circumstances, we looked for developments that purely economic factors could not account for. In brief we found:

- Little political impact on business investment; projected investment in 1977 varies enormously across industries and in nearly every case is clearly related to economic conditions in the particular industry.
- Only moderate political impact on flows of capital into and out of the country; while some inflows such as portfolio investment have weakened, signs of the often-rumored capital flight are lacking.
- A strong political impact on the stock market, where prices have fallen to levels that are incredibly low by standard economic criteria.

Business Investment Fairly Steady

Conventional wisdom holds that fear of a leftist victory is depressing investment outlays; businessmen who are surveyed frequently cite such concern. On the other side of the coin, both the present government and the Patronat—the influential employers federation—are pressing firms to invest now in the hope that the resulting boost to the economy will forestall a leftist election victory. While we cannot completely rule out a negative political impact on investment, we believe that, on balance, any such effect has been relatively small. French business investments apparently are being determined primarily by economic factors.

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The government's survey of business intentions for 1977 is probably the best indicator of investment plans available. The June survey points to a nominal increase of about 14 percent from 1976 outlays, corresponding to a real increase of 4 to 5 percent after allowance for inflation. Given the fact that excess capacity still is high by past standards in most industries, existing investment prospects seem at least reasonably satisfactory and indicate that political fears are not a major depressant.

Because business conditions vary widely among industries, disaggregated investment intentions reveal more than the total. The motor vehicle, petroleum processing, chemical, and electrical construction sectors all expect large increases in investment spending this year. All four industries have sound reasons for investment. For motor vehicles and electrical construction, large output gains over the past two years have squeezed excess production capacity. The petroleum sector must invest heavily in catalytic cracking equipment to meet an expected shift in demand from heavy fuel oil to lighter products. Spokesmen for the chemical industry forecast that its firms will be unable to meet demand by 1980 unless they begin expansion programs now.

At the same time that some industries are rapidly expanding capacity, a number of others are cutting investment spending. These include basic metals, paper, shipbuilding and aircraft, coal mining, leather, clothing, and textiles. This amounts to a roll call of the problem children of French industry—sectors whose immediate future is poor to mediocre regardless of election results. Most are already receiving special government aid in some form. Basic metals—especially steel—is the clearest case, for France suffers from the same excess capacity problems that affect most steel-producing countries. The paper industry, as well as the entire clothing and textiles sectors, is plagued by high costs and skyrocketing imports of foreign products. Coal continues its inexorable decline simply

France: Projected Increases in 1977

Business Investment

| Sector | Percent Change |
|----------------------------------|----------------|
| Glass | 74 |
| Automobiles | 48 |
| Oil and natural gas | 38 |
| Chemicals | 30 |
| Electrical construction | 21 |
| Machinery | 16 |
| Construction materials | 15 |
| Primary transformation of metals | 10 |
| Wood | 4 |
| Food industries | 1 |
| Printing and publishing | 0 |
| Textiles | -3 |
| Mining | -6 |
| Shipbuilding and aircraft | -9 |
| Paper | -10 |
| Clothing | -11 |
| Basic metal products | -17 |
| Hides and leather | -27 |
| Weighted Average | 14 |

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because French reserves are running low. Shipbuilding must retrench because of its nearly total failure over the past 18 months to garner new orders, while aircraft producers are in a similar situation due to poor sales of the Concorde and other civil airliners.

Capital Flows Generally Stable

Rumors of large-scale capital flight began to surface not long after the March 1976 local elections, in which the Socialist-Communist coalition made substantial gains. Analysis of this question unfortunately is hampered by the very long time lags before complete data are published. Detailed final balance-of-payments figures are available only through second quarter 1976 and detailed provisional figures through the third quarter. Partial data and press commentary indicate that France has experienced a net outflow of portfolio investment funds over the past year or so. Firms also are said to be shifting assets to foreign subsidiaries. The amounts apparently involved point to a moderate shift in investor behavior rather than to anything that might be labeled capital flight.

Data on overall short-term capital movements—available through first quarter 1977—also point to an absence of large-scale capital flight. *Private nonbank* flows as well as *errors and omissions* would likely be in the red if any large-scale capital flight were occurring. Yet both categories have remained steadily—and substantially—in surplus.

France: Short-Term International Capital Flows

| Million US \$ | | |
|---------------|--------------------|-------------------------|
| | Private Nonbank | Errors and Omissions |
| 1973 I | 698 | -81 |
| II | 125 | 286 |
| III | 635 | -229 |
| IV | 682 | -82 |
| 1974 I | 1,356 | -102 |
| II | 70 | 665 |
| III | 839 | 2 |
| IV | 249 | 637 |
| 1975 I | 912 | 517 |
| II | 847 | 576 |
| III | 924 | 720 |
| IV | 569 | 112 |
| 1976 I | 177 | -134 |
| II | 17 | 543 |
| III | 1,367 | 186 |
| IV | 408 | 633 |
| 1977 I | 1,393 | |

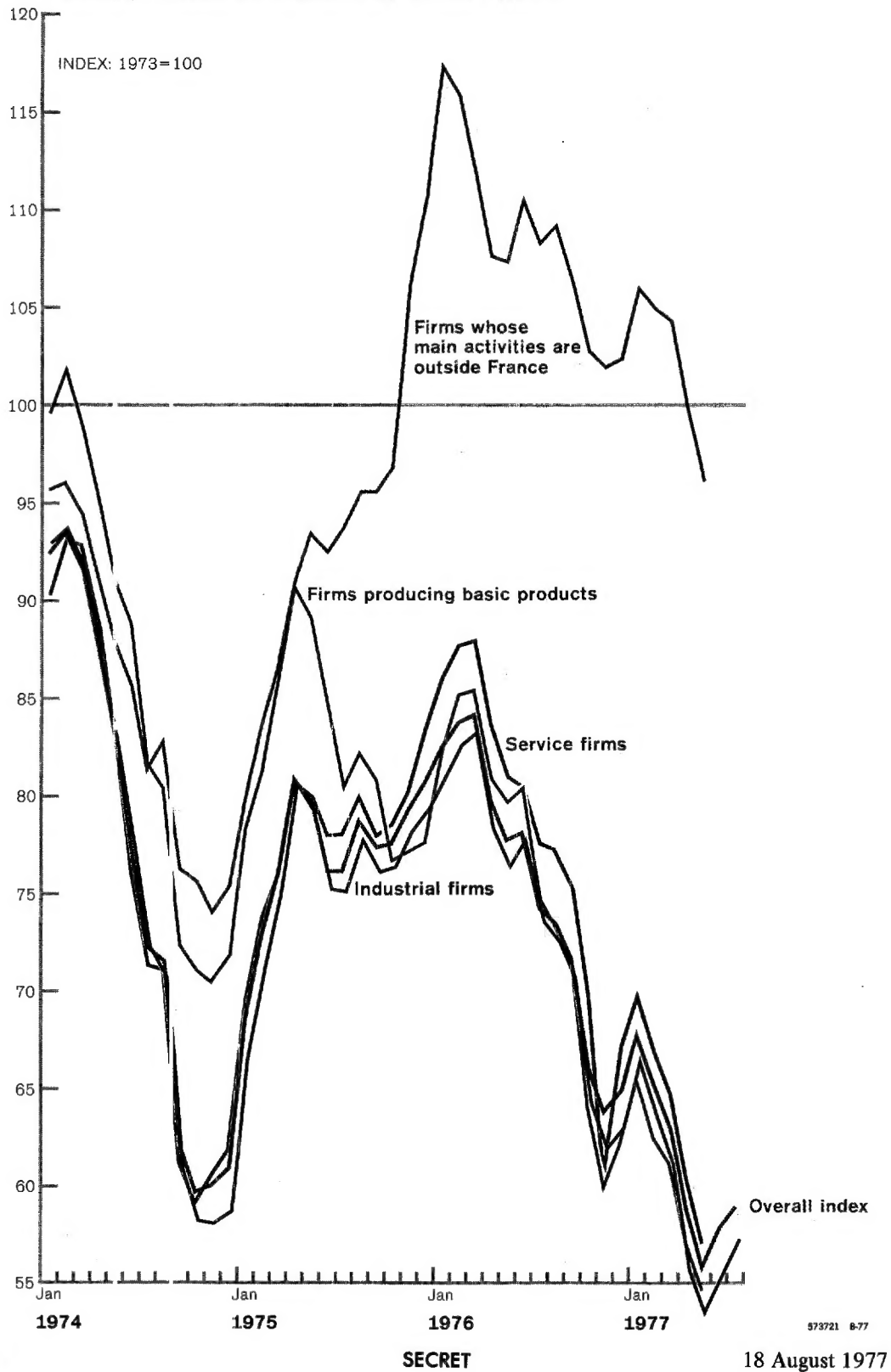
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FRANCE: Selected Indexes of Stock Prices



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Stock Market Prices Down

Fear of a leftist government clearly is depressing stock prices on the Paris Bourse. The average French stock can now be purchased for just half as many francs as in 1961, even though nominal GNP is now six times the 1961 level. Dividend yields on a number of stocks—including some blue chip issues—are in the 15-percent range. Moreover, stock indexes dipped in each of the last two years immediately after leftist victories in local elections. Significantly, the only stock category to resist the downtrend is made up of French firms whose principal activities are outside France.

This strong political impact on the stock market—in contrast to the comparatively weak effect on business investment—may reflect mainly the influence of psychological factors on stock price movements. The Paris Bourse is a relatively thin market and thus is especially volatile; French firms rely on internal resources and borrowed funds, rather than equity financing, for the bulk of their capital requirements. Another possible cause of the divergence between stock prices and business investment may be that stockholders are behaving as owners while corporate managers are behaving as salaried employees.

Stockholders have valid reasons for fearing a leftist government. The Socialist-Communist alliance already has targeted nine major companies* for nationalization, and pressure to extend the list is evident within the alliance. Moreover, leftist plans to boost social security charges and to allow big wage increases threaten corporate profits across the board. Finally, a leftist government would be likely sooner or later to increase personal income taxes on nonwage income such as dividends and capital gains.

Recent stock price behavior indicates that investor fears extend beyond the nationalization issue. The index for firms in the service sector is just as depressed as the index for manufacturers of basic products even though the former group should be much less affected by any program of nationalization.

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*In descending order of employment the nine are: Saint-Gobain-Pont-a-Mousson (construction materials, pipes and valves, packaging); Rhone-Poulenc (chemicals); Thomson-Brandt (electronics); Compagnie Generale d'Electricite (electrical equipment); Pechiney-Ugine-Kuhlman (metals, chemicals); ITT-France (telecommunications); CH-Honeywell Bull (computers); Dassault-Breguet (aircraft); Roussel-Uclaf (pharmaceuticals).

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UNITED STATES, JAPAN, AND WEST GERMANY: STRIKING DIFFERENCES IN RECENT FOREIGN TRADE PATTERNS

Exports and imports of the three most important non-Communist economic powers—the United States, Japan, and West Germany—have taken markedly different paths in the past 18 months.

The US trade account has shifted from approximate balance in first quarter 1976 to a record \$25 billion *deficit* in second quarter 1977.* In contrast, Japanese and West German *surpluses* rose by \$11 billion and \$4 billion. The sharp differences reflect (a) the much greater percentage increase in US oil imports as the United

Change in Trade Balances from 1976 I to 1977 II

| | Billion US \$ | | |
|---------------|----------------------------|--|--|
| | Change in Trade Balance | Change Attributable to Increased Oil Imports | Change Attributable to Nonoil Factors |
| United States | -25 | -16 | -9 |
| Japan | 11 | -1 | 12 |
| West Germany | 4 | -1 | 5 |

States became more dependent on foreign oil; (b) the more rapid rise in Japanese and West German sales to the United States than in US sales to the other two; and (c) an appreciation of both the yen and the mark relative to the dollar, particularly since third quarter 1976. While these currency changes significantly reduced US market shares in third-country markets in value terms, the US volume losses were small except in the non-OPEC LDC market vis-a-vis Japan.

Trade Patterns



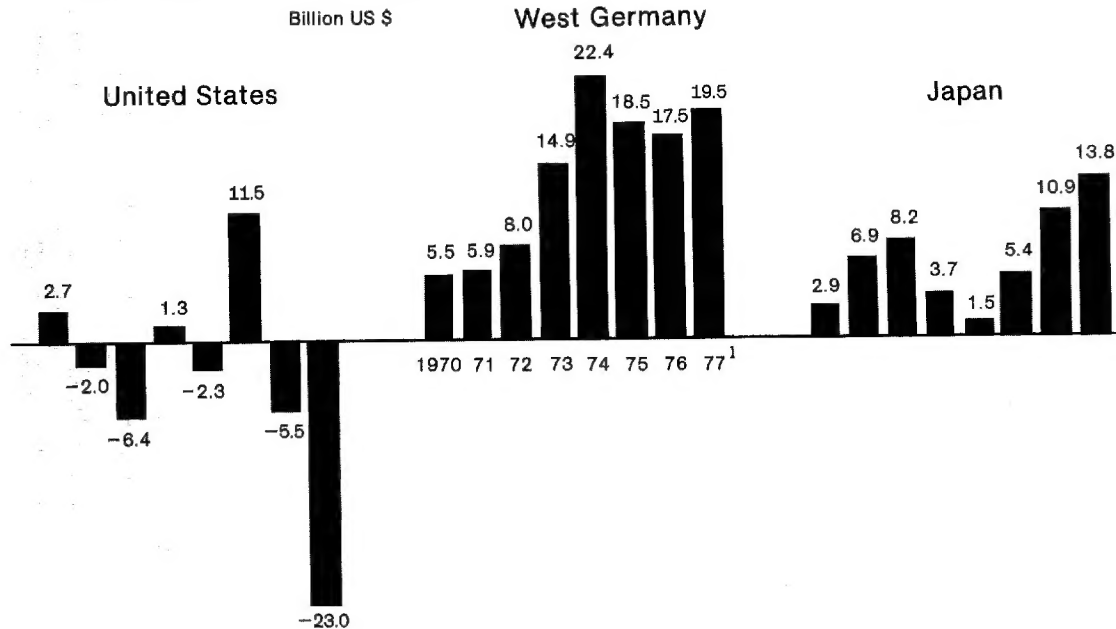
In the 1960s, all three economies normally had surpluses, with the United States enjoying the largest. Throughout most of the 1970s, in contrast, the United States ran sizable trade deficits, while the other two had large trade surpluses.**

*All trade figures and percentages in this article are expressed at annual rates. They have not been seasonally adjusted. Both exports and imports are f.o.b. and are derived from IMF *Direction of Trade* data.

**This article discusses merchandise trade only. In the case of service transactions, the United States has been able to sharply increase its surpluses, while Japan and West Germany have had enlarged deficits. Between the early 1970s (the average of 1970-72) and 1976, the US service surplus (including private transfers) rose \$15.7 billion. By comparison the Japanese service deficit increased \$4.1 billion, and the West German deficit increased \$3.8 billion.

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Merchandise Trade Balance (f.o.b./f.o.b.)



1. January-June at annual rate.

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In 1970-73, the US trade balance fluctuated between a \$3 billion surplus and a \$6 billion deficit, reflecting mainly cyclical factors and the impact of the dollar devaluations. For similar reasons the Japanese surplus varied between \$3 billion and \$8 billion. By comparison, the West German trade surplus grew steadily in the early 1970s on the strength of exports, reaching \$15 billion in 1973. [REDACTED]

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As a consequence of the 1973/74 OPEC price hike, the US and Japanese trade balances deteriorated sharply in 1974. West Germany actually increased its trade surplus to a record high in 1974; the volume of its oil imports is smallest of the three and its oil import prices rose less rapidly due to the product mix. [REDACTED]

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By 1976 the West German surplus had slipped \$5 billion from the \$22 billion peak; roughly half the lost ground had been regained by second quarter 1977. Since 1974 the Japanese have achieved rapidly expanding annual surpluses, reaching a \$17 billion rate in second quarter 1977. The US balance has followed a more erratic course. After a large surplus in 1975—the result of a deep cut in US imports—the trade account once again fell into deficit, reaching a record \$25 billion rate in second quarter 1977. [REDACTED]

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In gauging the factors affecting the recent divergence in trade patterns, we have focused on comparisons between first quarter 1976 and second quarter 1977. This approach helps avoid issues connected with the disruptive oil price hike of 1973/74 and the deep recession that followed. [REDACTED]

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Impact of Oil

Since early 1976, US imports of oil have skyrocketed \$16 billion—from an annual rate of \$29 billion to an annual rate of \$45 billion—while the oil imports of the other two major countries have risen about \$1 billion each. Several factors have contributed to the larger increase in US demand for foreign oil: [REDACTED]

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- The flat trend in US domestic crude production, with the resulting increase in dependence on foreign oil. [REDACTED]
- An unusually harsh winter in 1976/77. [REDACTED]
- A shift to oil fuels caused by the natural gas shortage. [REDACTED]
- A rapid buildup in inventories of petroleum products in second quarter 1977. [REDACTED]
- A more rapid revival in US industrial production than that of West Germany. [REDACTED]

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Even after the increase in petroleum imports is removed from the trade balance of each country, the relative deterioration of the US balance is sizable. [REDACTED]

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Nonoil Imports [REDACTED]

Differences in nonoil import growth contributed little to the contrasting trade performance of the three. US imports of nonoil products grew by 26 percent over the period on a yearly basis, whereas those of Japan and West Germany rose 22 percent and 19 percent, respectively. If the latter countries had increased nonoil imports as fast as the United States, the German surplus would have been \$6 billion lower, and the Japanese surplus would have declined by \$2 billion; US exports to the two countries would have increased by \$1 billion.

Export Trends [REDACTED]

Most of the difference in nonoil trade performance between the United States and the other two countries can be traced to export patterns. Between first quarter 1976 and second quarter 1977, US exports rose only 12 percent while West German exports climbed 17 percent and Japanese exports 28 percent. The contrast in growth

rates reflects mainly a 7-percent appreciation (annual rate) of the mark and an 8-percent appreciation of the yen against the dollar. If currency changes were removed, the dollar value of Japanese exports would have grown 19 percent and the West German rate would be about the same as the United States. This calculation assumes that the period is too short for the appreciation to have altered volume trends. [REDACTED]

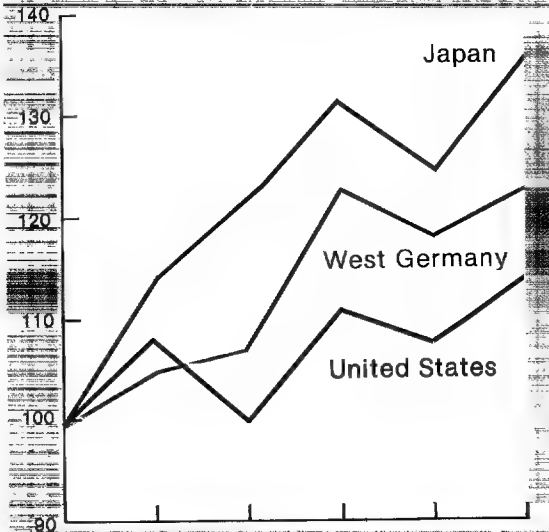
The initial impact of the exchange rate movements was to push up the dollar value of Japanese and West German exports at a faster pace than the dollar value of US exports in nearly every major country grouping. Among OPEC members and the other developed countries (that is, excluding the Big Three), the United States lost markets to Japan and West Germany when measured in value terms. [REDACTED]

US sales to Communist countries actually fell from early 1976 through mid-1977, mainly as a result of lower grain shipments. During the same period, West German sales climbed, while Japanese exports were little changed. [REDACTED]

The Japanese have expanded their position in the non-OPEC LDC market at the expense of both the United States and West Germany. The large increase in Japanese sales to the region—a 50-percent annual rate

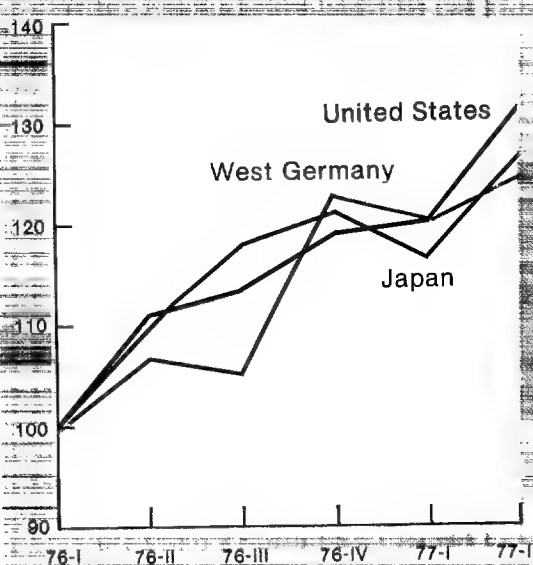
Merchandise Exports

Value Index: 1976 I = 100



Non-Oil Imports

Value Index: 1976 I = 100



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between first quarter 1976 and second quarter 1977—played an important role in overall Japanese export expansion. Of the \$21 billion increase in Japanese exports, \$10 billion went to the non-OPEC LDCs. Part of this superior Japanese performance results from the difference in Big Three market composition. Many LDCs whose economies and imports have slowed—for example, Mexico and Brazil—are important markets for the United States and West Germany but less so for Japan. On the other hand, the LDCs with fast growth rates, such as South Korea, Hong Kong, and Taiwan, are more important markets for Japanese goods. [REDACTED]

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A much different picture arises when market shares are measured in volume rather than value terms. At worst the US volume losses in OPEC and most other developed countries were small. In the case of non-OPEC LDCs, the Japanese wrested markets from both the United States and West Germany; the shifts occurred mainly in the Far East. [REDACTED]

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US Losses in Intra-Big Three Trade

A significant part of the swing in each country's trade balance is explained by trade patterns among the Big Three themselves. Between first quarter 1976 and second quarter 1977, Japanese and West German exports to the US market rose 30 percent and 36 percent, respectively. An increase in sales to the United States of \$5 billion accounted for about 25 percent of the rise in Japanese exports in this period. Although less than 7 percent of West German sales go to US buyers, the rapid increase in German exports to the United States boosted FRG export earnings by more than \$2 billion. [REDACTED]

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In sharp contrast, US sales to Japan rose at an annual rate of only 9 percent and to West Germany at 13 percent. The result was an increase in the US deficit with Japan of almost \$5 billion and with the FRG of about \$1 billion. Even after the impact of currency changes is eliminated, incremental Japanese and West German exports to the United States still topped US sales to the two by a wide margin. [REDACTED]

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Trade between West Germany and Japan also increased rapidly. German exports to Japan increased at a rate of 26 percent. Japanese exports to Germany grew 38 percent shoving the Japanese trade surplus with West Germany up by about \$1 billion. [REDACTED]

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Short-Term Outlook

We believe that the differences among the Big Three trade balances, while remaining large, will narrow slightly in second half 1977. US oil imports are expected to slow with the advent of Alaskan oil and the reduction of unusually high petroleum inventories. The strong surge in Japanese sales to the United States and West Germany is likely to moderate as a consequence of limits agreed to on exports of steel and television sets. Meanwhile, US sales to non-OPEC LDCs will probably pick up as imports by countries where the United States has a large market stake turn upward again. [REDACTED]

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OPEC CURRENT ACCOUNT: SURPLUS RECEDING FROM FIRST HALF HIGH

The OPEC current-account surplus reached \$25 billion in first half 1977, substantially above the \$19 billion of first half 1976. A sharp upturn in oil sales, especially to the United States, accounted for the lion's share of the increase. With oil liftings expected to fall off in second half 1977, the surplus will decline to as little as one-half the January-June level.

OPEC Countries Current Account Balance

| | Billion US \$ | | | |
|------------------------------------|------------------|------------------|------|-------------------|
| | 1st Half 1976 | 1st Half 1977 | 1976 | Projected 1977 |
| Trade balance | 31 | 38 | 64 | 65 |
| Exports, f.o.b. | 61 | 71 | 130 | 142-145 |
| Oil | 57 | 67 | 122 | 134-137 |
| Nonoil | 4 | 4 | 7 | 8 |
| Imports, f.o.b. | 30 | 34 | 65 | 77 |
| Net services and private transfers | -11 | -12 | -22 | -25 |
| Freight and insurance | -4 | -5 | -10 | -11 |
| Investment income receipts | 3 | 4 | 6 | 8 |
| Other | -10 | -11 | -19 | -22 |
| Grants | -1 | -1 | -2 | -3 |
| Current account balance | 19 | 25 | 40 | 37-40 |

For 1977 as a whole, we estimate a current-account surplus ranging from \$37 billion to \$40 billion, depending mainly on OPEC pricing policies and the weather; this surplus would approximate last year's. The 1977 estimate includes a lower second half surplus, projected at \$12 billion to \$15 billion. This reduced level (\$24 billion - \$30 billion at annual rates) is now expected to prevail through at least 1978.

Sharply Increased First Half Exports

OPEC oil earnings in first half 1977 climbed to a record \$67 billion, more than 15 percent above the same period last year. About 50 percent of the rise reflected higher oil prices and the remainder higher crude oil liftings. The overall 8-percent oil price increase is the weighted average of the 10-percent hike of 11 of the 13 OPEC members and the 5-percent increase of Saudi Arabia and the UAE, all effective 1 January 1977. OPEC oil exports—30 million barrels per day—were abnormally high

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in the first half. Exports usually fall after a price increase, as stocks built up in anticipation of higher prices are drawn down. After the January price increases, however, colder than normal weather kept winter demand high and oil companies were still replenishing stocks in the spring.

Imports Moving Up Moderately

Imports by OPEC members were \$34 billion in the first half—up 15 percent from first half 1976. The volume of goods purchased rose 7 percent, continuing the slackened pace evident since spring 1975. Indeed, the slower intake has allowed the mammoth backlogs at OPEC ports to be sharply reduced. OPEC import prices stood 6 percent above first half 1976, partly reflecting the appreciation of the yen, the mark, and other currencies against the dollar.

Country Positions

Ten OPEC members achieved current-account surpluses in first half 1977. Saudi Arabia once again led the pack with an \$11 billion surplus.

Besides the current account surplus, OPEC reserve positions benefited from a tightening of credit terms on oil sales. After the January 1977 price hike the majority of OPEC members adopted an average 60 days credit for oil sales compared with 90 days last year. Algeria, Ecuador, Nigeria, and Venezuela set payment due dates for some of their crude as short as 30 days. As a result of the shortened credit terms, \$4.9 billion more in oil receipts flowed into OPEC coffers on a one-time basis. Official reserves thus rose roughly \$30 billion to about \$160 billion as of 30 June 1977.

Second Half Trends

We estimate that the second half 1977 surplus will fall off sharply due to reduced OPEC oil sales. Consumers are expected to draw down their unusually high oil stocks in the third quarter, and non-OPEC supplies—Alaskan North Slope and North Sea—will be rising throughout

**OPEC Countries:
Current Account Balances**

| | Billion US \$ | |
|--------------|--------------------------|--------------------------|
| | 1st Half 1976 | 1st Half 1977 |
| OPEC | 19.4 | 24.9 |
| Saudi Arabia | 8.5 | 10.8 |
| Iran | 2.5 | 3.3 |
| UAE | 2.7 | 3.0 |
| Kuwait | 2.5 | 2.4 |
| Libya | 1.1 | 2.0 |
| Iraq | 1.0 | 1.5 |
| Venezuela | 0.9 | 0.9 |
| Indonesia | -0.1 | 0.7 |
| Nigeria | 0.2 | 0.6 |
| Qatar | 0.7 | 0.5 |
| Gabon | 0 | -0.1 |
| Ecuador | -0.1 | -0.1 |
| Algeria | -0.7 | -0.7 |

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the six-month period. OPEC imports are assumed to continue to climb at the moderate pace of recent months. This yields a second half surplus of \$12 billion to \$15 billion, depending on how oil demand is affected by winter weather and by how much companies build stocks in the last quarter in anticipation of a possible 1 January 1978 price rise.

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Among the OPEC countries, Indonesia, Nigeria, and Venezuela probably will move into the red in the second half. Although Saudi Arabia is expected to absorb by far the largest share of the export cut, its oil revenues will remain at first half levels because Riyadh hiked prices by 5 percent on 1 July 1977.

For the year as a whole the OPEC surplus is likely to run from \$37 billion to \$40 billion, approximately the same as in 1976. With OPEC oil export volume remaining at the same level in both years, the higher oil prices and the growth in investment income will just about cover the increase in imports of goods and services.

Beyond 1977

We now expect that the \$24 billion to \$30 billion surplus (annual rates) projected for second half 1977 will last at least through 1978. This assumes that (a) oil prices rise at the same rate as global trade prices; (b) the volume of OPEC imports increases at about 10 percent; and (c) OPEC liftings level off as non-OPEC supplies expand.

* * * * *

SOVIET GRAIN PROSPECTS STILL EXCELLENT

Based on crop conditions as of early August, CIA estimates that the USSR will have a second consecutive bumper grain crop between 220 million and 225 million tons. USDA's current estimate is 220 million tons with a "two-thirds chance" that output will be between 205 million and 230 million tons. A high-ranking Soviet agricultural expert told US reporters last week that this year's production would be 225 million tons. Quality may suffer, however, because of wet harvesting conditions in some winter grain areas. The demand for milling quality grain can be filled by imports which could reach 14 million tons in the year beginning this October.

The current estimate compares with our early July estimate of 225 million tons. The range reflects slightly lower soil moisture levels in parts of the spring grain area east of the Urals. The primary swing factor is output in Kazakhstan, where roughly 40 percent of this year's spring wheat will be harvested. If soil moisture

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USSR: Grain Production

| | Million Tons | | | | | | |
|---------------|--------------|--------------|--------------|--------------|--------------|--------------|-------------------|
| | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 ¹ |
| Total | 181.2 | 168.2 | 222.5 | 195.6 | 140.1 | 223.8 | 220-225 |
| Winter grains | 63.0 | 40.6 | 63.5 | 62.5 | 48.7 | 60.9 | 72 |
| Of which: | | | | | | | |
| Wheat | 47.8 | 29.4 | 49.4 | 44.7 | 36.7 | 44.6 | 57 |
| Rye | 12.8 | 9.6 | 10.8 | 15.2 | 9.0 | 14.0 | 13 |
| Spring grains | 118.2 | 127.6 | 159.0 | 133.1 | 91.4 | 162.9 | 148-153 |
| Of which: | | | | | | | |
| Barley | 32.3 | 35.1 | 51.7 | 51.6 | 32.9 | 67.1 | 59-60 |
| Wheat | 51.1 | 56.6 | 60.5 | 39.2 | 29.6 | 52.3 | 48-50 |

¹Estimated.

levels here remain adequate through August, the upper limit of the range could result.

Much of the success of the 1977 grain crop rests on the unusually large production of winter grains. CIA estimates winter grain production at 72 million tons, compared with 61 million tons in 1976 and an average of 56 million tons in 1971-75. Last year's winter losses were more than one-fourth of the crop; this year's winter grains sustained only moderate damage, leaving a record area to be harvested.

In the major spring grain region east of the Urals, localized showers have produced an irregular pattern of crop development. Because of uncertainty about the overall impact of these rains, we project total spring grain production to range from 148 million to 153 million tons. Last year, Soviet spring grain production reached a record 163 million tons. In European USSR, prospects continue for above-average spring grain yields; moderate temperatures and above-normal precipitation have prevailed since early spring.

Despite unusually wet conditions in some areas, the progress of this year's grain harvest is ahead of the five-year average and substantially faster than in 1976. By 1 August, grain and pulse crops, excluding corn, were cut on 44.4 million hectares—slightly more than one-third of this year's crop area. In addition, the Soviets reported that about four-fifths of the cut grain had been threshed, a

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considerable improvement compared with earlier progress reports. The rapid harvest of winter wheat and its high moisture content may jeopardize its quality. Chances are that some of this wheat will not be suitable for milling or breadmaking.

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With at least three-fourths of the spring grain east of the Urals remaining to be cut, final output is far from certain. Only average harvest losses and continued favorable weather conditions east of the Urals are required to ensure a bumper crop. In West Siberia a late harvest is often caught by snow and frost that occur in late September and early October.

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A small part of rumored Soviet grain imports in the year beginning this October have been confirmed—5.5 million tons out of a possible 14 million tons. The size of US sales is the unknown. Only 1.7 million tons have been reported to USDA

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CHILEAN PAYMENTS POSITION: BREATHING SPELL*

Two years of harsh austerity have reduced Chile's financial gap to manageable size. The military junta is now gradually easing austerity and allowing imports to grow 15 to 20 percent this year. Although Santiago is counting on increased commercial bank and supplier credits, it will have to draw heavily on its small foreign reserves to cover this year's projected \$900 million financial gap.

The military government's ability to further relax demand management policies will be constrained by sluggish copper prices and difficulties in obtaining more foreign capital. Availability of foreign funds depends partly on the junta's willingness to curb its human rights violations. The recent announcement that the government has disbanded the National Intelligence Directorate (DINA) seems a genuine effort to curtail past abuses and modify the most severe aspects of political repression. Given the prospects for aid, even with improved human rights policies, Chile's growth for the next few years will not support a sharp rise in the living standards of most of the population.

The Allende Legacy and the 1975 Crisis

Chile's precarious payments position—in large part the aftermath of economic mismanagement by the Marxist regime of Salvador Allende (1970-73)—became a

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financial crisis in 1975. The crunch was triggered by the collapse of world copper prices and the coming due of large scheduled debt repayments, which pushed the current account deficit to \$580 million and the financial gap to \$1.1 billion. The gap was closed only by postponing roughly a third of the \$730 million in scheduled debt repayments.

Chile: Foreign Financial Gap

| | 1973 | 1974 | 1975 | 1976 ¹ | 1977 ² |
|---|---------------|-------------|---------------|-------------------|-------------------|
| | Million US \$ | | | | |
| Exports, f.o.b. | 1,267 | 2,244 | 1,570 | 2,077 | 2,000 |
| Imports, f.o.b. | 1,363 | 1,821 | 1,577 | 1,412 | 1,650 |
| Net services and transfers | -363 | -626 | -571 | -612 | -680 |
| Current account balance | -459 | -203 | -578 | 53 | -330 |
| Debt amortization | -407 | -367 | -524 | -556 | -589 |
| Financial gap | -866 | -570 | -1,102 | -503 | -919 |
| Medium- and long-term capital inflows | 646 | 742 | 1,051 | 890 | 730 |
| Direct private investment | 0 | -98 | 50 | 80 | 90 |
| Official lending agencies | 172 | 310 | 516 | 463 | 180 |
| Bilateral debt relief | 352 | 287 | 232 | 0 | 0 |
| Private foreign credit | 122 | 243 | 253 | 347 | 460 |
| Net short-term capital and errors and omissions | 251 | -250 | 59 | -42 | 0 |
| Change in reserves | 31 | -78 | 8 | 345 | -189 |
| External debt at yearend (including short term) | 4,218 | 4,849 | 5,225 | 5,725 | 5,776 |
| | Percent | | | | |
| Debt service ratio | | | | | |
| Due | 36 | 24 | 41 | 33 | 35 |
| Paid | 11 | 12 | 28 | 33 | 35 |

¹Provisional.

²Projected.

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To prevent an even larger deficit and dampen runaway inflation, the new military government—which had seized power in September 1973—imposed one of the harshest austerity programs seen anywhere in the past 25 years. Private sector credit all but disappeared in 1975, while government spending was slashed by one-fourth. The squeeze on domestic demand cut the volume of foreign purchases by nearly one-fifth; real GDP fell 13 percent, and industrial output plummeted 28 percent. From the viewpoint of the military government, such unpopular and wrenching changes could be installed only by tightening the junta's already strong political grip on institutions and individuals in the society.

Restoring Equilibrium in 1976

The effects of stringent austerity carried over to 1976 when import volume fell another 13 percent, dropping to about the 1972 level. At the same time, Chile benefited from the recovery in copper prices and from rapidly expanding noncopper exports, the result of (a) a vigorous export promotion campaign and (b) devaluation of the peso roughly in line with the country's triple-digit inflation. Total exports gained more than 30 percent in value, allowing a small current account surplus and more than halving the financial gap to \$500 million.

By narrowing the gap, Santiago was able to meet scheduled debt repayments for the first time since 1971. Private foreign lenders, encouraged by the government's belt tightening and improved ability to repay debt, provided about a \$100 million increase in long-term capital last year, more than offsetting a fall in official lending brought on by Chile's human rights policies. These funds, together with \$80 million in direct investment inflows, closed the financial gap and permitted a substantial increase in foreign exchange reserves. By yearend, reserves amounted to about four months' imports.

The improved payments situation paved the way for gradual easing in fiscal and monetary restraints beginning in mid-1976. Despite somewhat easier private credit and increased foreign demand, real GDP rose only 3.5 percent and industrial output recovered by a mere 6.5 percent. The strongest revival occurred in the copper industry where output last year averaged 1 million tons, up from 828,000 tons in 1975. The growth in economic activity barely put a dent in the record number of jobless. The inflation rate, fueled by continued large budget deficits and parallel monetary growth, averaged 174 percent for the year as a whole, compared with 341 percent in 1975.

The 1977 Payments Situation

We expect Chile's financial gap to widen by more than 80 percent this year, to about \$900 million. Although foreign sales are being buoyed by noncopper export earnings, sagging copper demand and prices will prevent any increase in total

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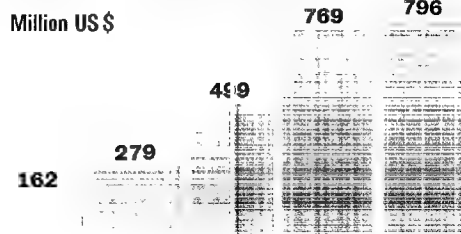
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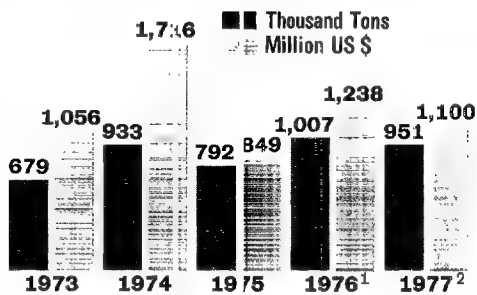
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Economic Indicators

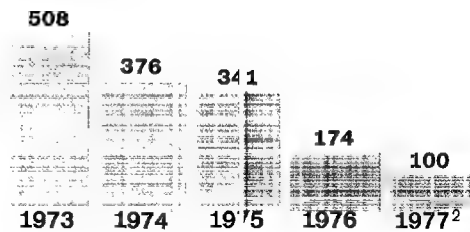
Foreign Debt Service Payments



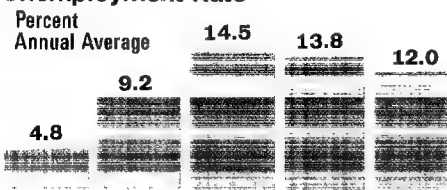
Copper Exports and Earnings



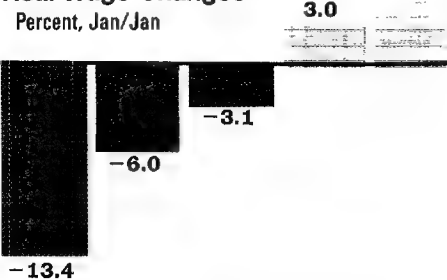
Inflation Rate Percent, Dec/Dec



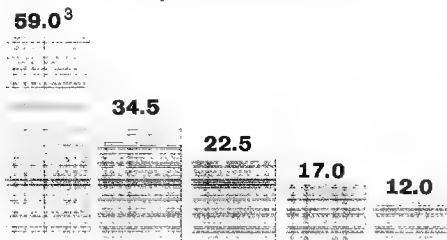
Unemployment Rate



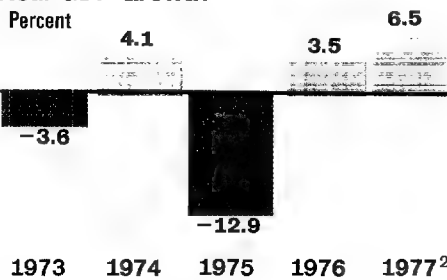
Real Wage Changes



Central Government Deficit as a Percent of Expenditures



Real GDP Growth



1. Estimated

2. Projected

3. Including large-scale deficit spending not reported in the official budget.

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exports. Copper shipments this year will approximate 951,000 tons, down 6 percent from last year, while copper earnings are projected to slip more than 10 percent.

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At the same time, Santiago is providing enough reflation to induce a 15- to 20-percent rise in imports, leaving a trade surplus of \$350 million this year. The deficit in transportation, other services, and interest payments, together with debt amortization costs, will leave Chile with the estimated financial gap of about \$900 million in 1977.

The military government is relying on commercial bank borrowing and expanded use of supplier credits to finance the payments gap. Anticipating criticism and pressure from the United States and other creditors for its human rights practices, Santiago has foregone negotiations for debt relief again this year. For the same reason, borrowing from bilateral and multilateral sources are off sharply. Funds from these sources will amount to less than half of last year's inflows. Direct investment will not grow much, partly because of bureaucratic delays in approving new projects. Consequently, a reserve drawdown of nearly \$200 million probably will be required this year.

To keep import growth within bounds and maintain progress against inflation, the junta is staying with its plan to ease austerity measures only gradually. Real wages this year are being allowed to increase only about 5 percent, leaving them still well below 1972 levels. On the budgetary side, Santiago's program calls for moderate tax reductions, small increases in social spending, and some limited wage increases for government workers. In these circumstances, Santiago will run a budget deficit equal to 12 percent of government expenditures, 5 percentage points smaller than last year. Consumer credit is also being eased, but not very fast.

On balance, we estimate that these measures will allow real GDP to rise by close to the junta's 6 to 7 percent target this year. Real output for 1977 will still be slightly below the 1974 level; unemployment will remain at about 12 percent; and inflation is likely to average about 100 percent. Given the authority of the junta, Chilean labor is in no position to protest the slow revival in its real income. The business community for its part still feels it is better off under the present regime than under the Allende government.

Looking Ahead

Unless world copper prices rise more than can reasonably be expected, the military government will be unable to further relax its austerity measures over the next few years and may have to tighten them again. Debt amortization payments will not begin to decline until after 1980, and obtaining external financing will continue to be a serious problem. By yearend, foreign reserves will be down to two months' import cover and thus cannot continue to underwrite increased imports.

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Without higher copper prices, Santiago needs \$800 million to \$900 million a year in gross capital inflows if the junta's target of 6 to 7 percent economic growth is to be met. Even though the junta seemingly is relaxing its human rights attitudes, Chile cannot count on filling much of the gap with bilateral or multilateral financing.

Substantial increases in direct foreign investment are also unlikely over the next few years. The prospect thus is for prolonged constraints on imports, slower economic growth, and continued high unemployment levels. [REDACTED]

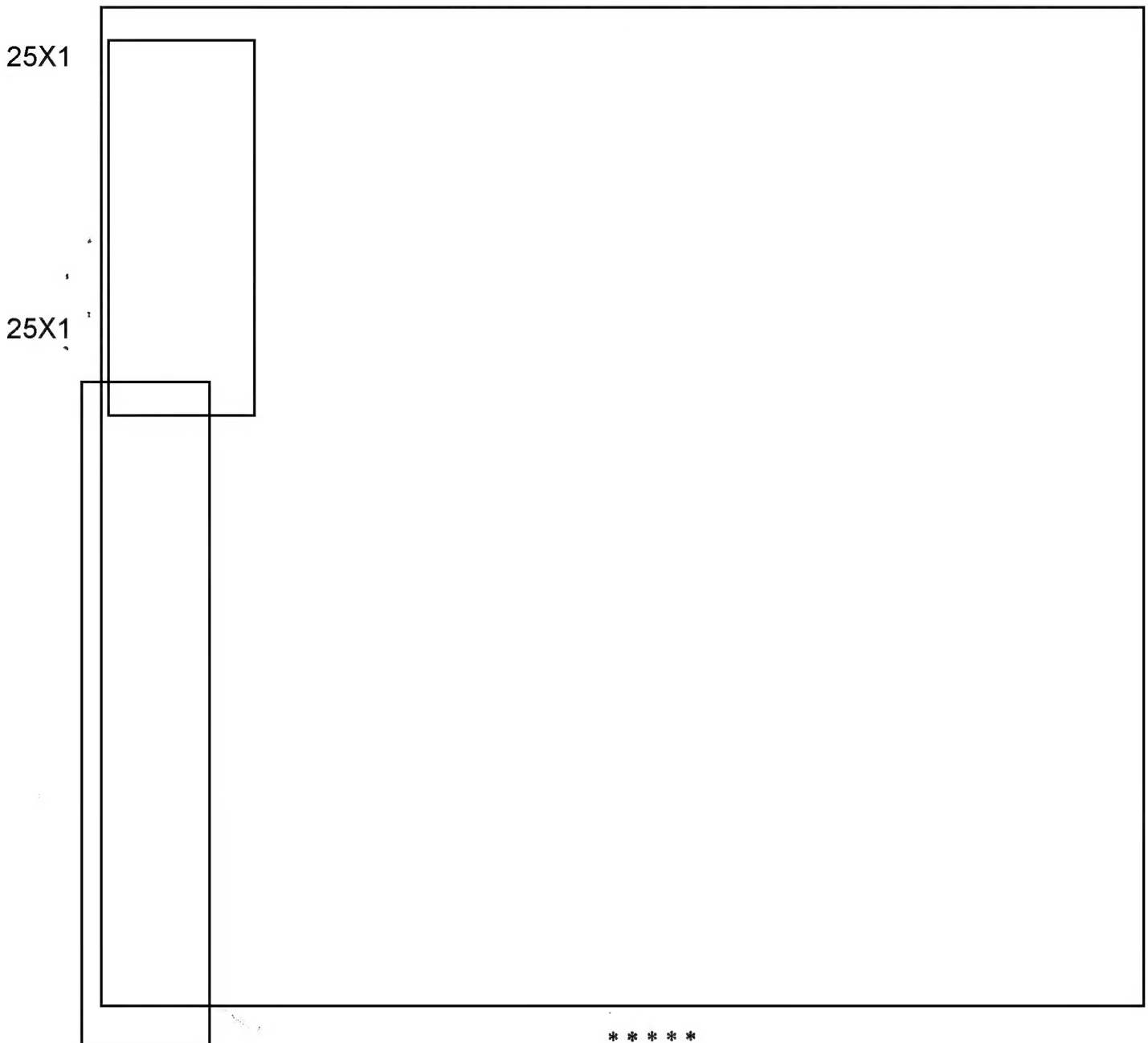
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Note

Coffee: Another Producer Attempt To Support Prices

Brazil's recent purchases of large amounts of coffee on the world market and its suspension of coffee sales during the last few months probably have had little

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effect on world prices. El Salvador's heavy buying on the futures market also has failed to boost prices. Prices have stabilized in recent weeks at about \$2.00 per pound after having fallen from nearly \$3.40 in mid-April, primarily because of some revival in roaster demand.

Other coffee-producing countries are pushing for measures to arrest the price decline. Contacts among leaders of the exporting countries are increasing, and there is talk of (a) a defense fund (possibly financed by Venezuela) to support the market, (b) a possible revision of the International Coffee Organization, and (c) new attempts to form an exporter's cartel. The coffee producers were unable to achieve effective cooperation during 1972-74 and probably will have no greater success this time. [REDACTED]

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